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Building a better working world

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The electoral campaign – a battle without rules?

Although it has probably not been very obvious in recent months, election campaigning in the Czech Republic has rules set by law. What is the importance of ethics in campaigning and what conduct is already beyond the boundaries set by law?

Unless you've been on a long vacation or business trip for the last few months, you certainly couldn't have missed it. The election campaign and now the election of the head of state are behind us. It has been described by some political analysts and journalists as the most heated and contentious of all presidential election campaigns in the modern history of our country. I also remember quite vividly both previous direct elections and, compared to the campaign that has just taken place, I would probably agree with this assertion. However, it's also possible that selective memory is at work here, trying to displace negative experiences, since previous campaigns were certainly not conducted in the spirit of fair play (unless there's something impossible about the very combination of the terms "election campaign" and "spirit of fair play").

I'd like to assure our esteemed readers that the purpose of my editorial today is not to add another political commentary to the pile of already published analyses and opinions. As an attorney, I'd like to look at the legal regulation of election campaigns and try to summarize the boundaries within which individual candidates and especially their marketing teams move during the campaign and how realistic it is that they sometimes cross that boundary. Most of us – those who follow the political scene with an eye toward maintaining our sanity – suspect that there are rules about campaign finance or the release of polls at some point in the run-up to an election. After looking into the Presidential Election Act, however, I was surprised by the detail of the legal regulation. Indeed, I don't come across this kind of legal regulation very often in the practice of law.

I was perhaps vaguely aware that persons entering an election campaign in support of a candidate would be required to register with the Office for Supervision of the Management of Political Parties and Political Movements. This is actually only because in 2013, during the first direct elections, there was a lot of discussion about a full-page ad in a tabloid newspaper slandering one of the candidates. The advert at the time did not contain any indication of a registered supporter of the other candidate and thus clearly breached the legal rules. Incidentally, this database of supporters is also publicly available on the Authority's website for this year's elections and it would probably be interesting to try to make a comparison between the sponsors of individual billboards and the officially declared group of supporters. I would hazard a guess that the first group would be considerably larger (again, strictly speaking, in violation of the law).

However, I was very surprised that the Presidential Election Act contains a provision that literally reads "The election campaign must be conducted honestly and fairly, and in particular no false information about candidates may be published." Does the law directly define campaign rules in this way, even referring to the concepts of "honesty" and "integrity"? Did the legislature really run the risk of someone arguing and proving in a court of law what is true and what is false? We can all remember examples from the past when blatantly false information was published about individual candidates. So is this an empty provision of the law? As you may have guessed, it's not that simple. The Supreme Administrative Court's decision in the proceedings on the invalidity of the presidential election concerning the first direct presidential election held in 2013 will help us to find answers to these questions.

Many of us will remember that the election campaign at that time, right from the first direct election, showed that in the pursuit of votes some candidates didn't worry too much about what was honest and fair. In the court proceedings, the appellant listed a total of twelve "fouls" that the then presidential candidate and Minister of Foreign Affairs Karel Schwarzenberg had had to face. This included, among other things, the deliberate distortion of statements about the legal nature of the so-called Benes Decrees, the publication of patently false information about the use of Nazi symbols in Mr. Schwarzenberg's ancestral residence, completely fabricated information about the alleged support of a representative of the Sudeten German Regional Association, or the publication of the aforementioned false and misleading advertisement on the first day of the second round of the elections.

In the reasons for its decision, the Supreme Administrative Court agreed with the appellant's view that many of the above-mentioned claims made to voters during the election campaign "may have appeared to many people to be unfair, demagogic and some even false." The court then also stated that any invalidation of an election must be a wholly exceptional decision, as it interferes with the decision of the electorate as the sovereign of the electoral system. For such intervention, the court defined the following three conditions – (i) the illegality of the conduct, (ii) the relationship between that illegality and the election of the winning candidate, and (iii) the fundamental intensity of that illegality. Intensity may consist not only in one intensive illegal act, but also in the accumulation of a greater number of weaker illegal acts. In this context, the Court used L. L. Fuller's simile "most of the injustices of this world are not committed with fists, but with elbows."

In the reasons for its decision on the merits, the court presented a detailed analysis of its above three conditions for the possible invalidity of the election. First, it stated that the concepts of "honesty and integrity" cannot "be identified with good morals as understood by the Civil Code in the context of an election campaign, nor can they be judged in terms of private law and general morality. Lack of ethics in an election campaign does not necessarily make such conduct unlawful." So the question of ethics is settled in the election campaign.

In particular, the court considers the timing of each possible illegal act to be crucial and essential, which in my view actually extends its own conditions for invalidating an election to four. The court found that the opponent had the opportunity to respond to almost all of the alleged unfair arguments in the campaign. In the reasoning of the decision, the court specifically stated that "even an apparently serious foul, which occurs long before the voters vote, will not significantly affect the election result, since the candidate in question can respond to it in an appropriate manner and, in the end, may even benefit politically from it." With a certain amount of cynicism, the court's opinion could be interpreted to mean that you can lie in an election campaign, you just have to stop in time.

However, the election campaign at issue in the court case also produced clearly illegal conduct that simply could not pass this "time test", since the advertisement in the national daily was published on the first day of the second round of the election. Readers were therefore able to read it the morning before the polls opened and the other candidate did not have a chance to respond to the ad. The court therefore had to address the fulfilment of its third condition set out above, i.e. the existence of a substantial degree of illegality. While noting that the newspaper in question had a daily circulation of 300,000 and reached approximately 1 million voters with its content, the court concluded in the reasons for its decision that "despite the high intensity of the illegality, the advertisement was not capable of changing the election results," as the overall result of the election was significantly in favour of the other candidate, with nearly 500,000 votes. I don't know about you, but I get the sense from this decision that the court's interpretive conditions effectively preclude the effective application of the statutory rule of election illegality. If there is already an obvious and highly intense illegality to which the aggrieved candidate could not respond, the election would still have to end in a close enough result to even consider invalidity.

How to end my commentary at least partially positively? Oddly enough, I can borrow another sentence from the court decision under discussion for a positive conclusion. In its reasoning, the court also used the following quote from political science literature – "an exceptionally aggressive style of negative electioneering can have a counterproductive effect, i.e., it can backfire on its initiator and, as a result, reduce the number of votes received in an election." Let's just hope that this risk will be taken into account by candidates in future elections in which a positive campaign aimed at presenting individual electoral programs prevails.

Most of us – those who follow the political scene with an eye to maintaining our sanity – suspect that there are rules about campaign finance or the release of polls at some point in the run-up to an election. However, after looking at the Presidential Election Act, I was surprised by the level of detail in the law; after all, I don't come across this kind of legislation that often in the practice of law.

Pillar 2

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Pillar 2 of BEPS 2.0 - from 2024 already – does is concern us?

The implementation of Pillar 2 of BEPS 2.0 has been approved at the EU level. We have informed you about the parameters, the negotiation and approval process in our alerts (e.g. we described the basics of the calculation HERE). In December, the EU directive was approved on the basis of which Pillar 2 will also be implemented in the Czech Republic (more information in our article HERE).

The introduction of Pillar 2 will result in an unprecedented link between the accounting books kept under the IFRS and the tax calculation under Pillar 2. The rules are extremely complex, full of exceptions and elections and each large Czech group and a local subsidiary of a large foreign group should already be thinking about how to deal with this complex piece of legislation. Time is running out. The Directive should be in effect as early as 2024.

We below reflect on 4 selected basic theses that we encounter (and try to refute):

We (don't) file a CbCR and therefore the rules (don't) apply to us

Yes and no. It is true that the basic threshold for the notification of a Country-by-Country Report (CbCR) also applies to Pillar 2, i.e. the annual consolidated revenues of a multinational enterprise group of companies are at least EUR 750 million. However, Pillar 2 also applies, among others, to large-scale domestic groups and furthermore contains special rules for minority-owned constituent subgroups, joint ventures, investment funds etc. with a lot of exceptions and additional conditions that may lead to unexpected conclusions regarding (non)inclusion in the Pillar 2 rules.

Our statutory or book effective tax rate is higher than 15%, so we are not affected

Hard to say. The Directive contains its own definition and method of calculating effective tax, both on the numerator (i.e. covered tax) and denominator (i.e. net income) side. Covered tax will e.g. include deferred tax that will be recalculated at a maximum of 15% tax (regardless of the rate used for accounting purposes). Although net income will be based on the IFRS accounting books, the Directive contains a list of items by which profit/loss will need to be adjusted. Some book items may affect the effective tax rate purely because there is a (temporary or permanent) difference between Czech "tax accounting" and IFRS books - some combinations of differences and recalculation of deferred tax may lead to unpleasant consequences. Various deductions, allowances and credits that will affect the amount of tax should be considered separately as well.

Our foreign head office will deal with this, we don't have to do anything locally

They won't - at least not by themselves. If you have a foreign headquarters, Pillar 2 will be (simplistically and just for you) an exercise where you will need to explain various items that enter the Czech tax base (including any differences between IFRS and Czech profit or loss), and thus, affect the current (and deferred) tax which further affects the covered tax for Pillar 2 calculation.

We have the ultimate parent company outside the EU, and therefore, the rules do not apply to us

On the contrary. If your ultimate parent company is located outside the EU and such jurisdiction has not implemented rules equivalent to those set out in the Directive or the OECD Model Rules, Pillar 2 will apply at the level of the EU intermediate parent entity, or the rules for undertaxed profits will apply.

We will continue to monitor this initiative and everything related to it.

If you are interested in this area, please contact the author of the article or your usual EY team.

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Pillar 2 – focusing on safe harbours

It sounds a bit like the title of a nautical novel, but it's not. It's about Pillar 2 and its dark tax corners.

In December 2022, a new EU Directive on ensuring a global minimum level of taxation for multinational enterprise groups or large-scale domestic groups ("the Directive") came into force. We introduced the main parameters of this Directive in the last issue of Tax News (HERE) and who is affected by these rules is discussed in the previous article.

In this article we will focus on one aspect – the topic of safe harbours.

What the Directive says

Article 32 of the Directive states that Member States shall ensure that, at the election of the filing constituent entity, the top-up tax due by a group in a jurisdiction shall be deemed to be zero for a fiscal year if the effective level of taxation of the constituent entities located in that jurisdiction fulfils the conditions of a qualifying international agreement on safe harbours.

The 'qualifying international agreement on safe harbours' means an international set of rules and conditions which all Member States have consented to and which grants groups in the scope of the Directive the possibility of electing to benefit from one or more safe harbours for a jurisdiction.

The OECD document

In late December 2022, the OECD (Inclusive Framework on BEPS) published, among other things, a guidance document on the rules for transitional safe harbours in the context of Pillar 2.

Simply put, under these transitional safe harbour rules (for the years 2024 through 2026) a jurisdiction would drop out of the application of the Pillar 2 GloBE rules top-up tax for a given year if

- its revenue and pre-tax profit determined in accordance with the CbCR would be below the thresholds of EUR 10 million and EUR 1 million respectively (*de minimis test*) or
- its simplified effective tax rate (determined using financial statements and the CbCR) would be at least at the minimum required percentage for the year – a gradually increasing 15%/16%/17% (*the simplified ETR test*) or
- its profit before tax (according to the CbCR) would be equal to or less than the substance-based income exclusion amont (*the routine profit test*).

Although this is intended to be an optional simplification, the guidelines contain a number of not-so-simple exceptions and special rules.

The OECD document also comes up with the concept of permanent safe harbour rules – these could be similar in nature to the transitional ones, with the detailed calculations and source data modified – but the complexity of the calculations is still supposed to be reduced compared to the "standard" of full GloBE rules.

The OECD document specifies, among other things, that separate work is being done on safe harbour rules for the application of a qualified domestic minimum tax-up tax.

It remains to be seen whether and in what concrete way these 'simplifications' will eventually 'translate' into the practical application of the Directive, whose application is imminent.

We will continue to monitor this initiative and everything related to it.

If you are interested in this area, please contact the author of the article or your usual EY team.

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Investment incentives

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Investment Incentives Act amendment increases and simplifies support for energy savings and semiconductors

We've already informed you about the forthcoming Investment Incentives Act amendment and the relevant implementing regulation in our September Tax News. The inter-ministerial comment procedure has recently been completed and the draft amendment is expected to be discussed by the government in the near future.

Approval of investment incentive applications

The amendment should abolish the obligation to submit every application for an investment incentive to the government for consideration, so the decision should again be made by the Ministry of Industry and Trade on the basis of the opinions of the ministries concerned. Only applications relating to strategic investments, i.e. investment projects where material support is provided for the acquisition of tangible and intangible fixed assets, should continue to be submitted to the Government.

The Ministry of Labour and Social Affairs, the Ministry of Finance, the Ministry of Agriculture and the Ministry of the Environment will assess the prerequisites for meeting the general and specific conditions for granting investment incentives. In addition to the conditions and obligations set out in the Investment Incentives Act and other implementing regulations, the ministries concerned should also assess the benefits of the investment project for the state and, on the basis of this assessment, issue binding opinions in which they agree or disagree with the granting of the investment incentive.

The amendment to the Investment Incentives Act, which imposes on the ministries concerned the obligation to evaluate the benefits of investments for the state, in addition to the conditions set out in the Government Regulation, was added on the basis of a substantive comment made by the Ministry of Finance. However, the Union of Employers' Associations disagrees with this change and the amendment is being submitted to the Government with a contradiction. The Union (rightly in our view) argues that this is too abstract a concept that fails provide clear criteria and will therefore not lead to the necessary increase in transparency.

To illustrate the current status of the approval of investment incentive applications: of the 38 projects decided by the Government so far, a total of 21 projects have been rejected, while all 38 projects fulfilled the conditions set out in the Investment Incentives Act and the Regulation. According to a comparison carried out by the CzechInvest agency, applicants were most often rejected on the basis of the company's low involvement with research and development (failure to meet the condition of higher added value), even in state-supported regions where this condition is not required by the Regulation. The second most common reason for rejection was that the amount of investment was too small, even though all applicants met the minimum level of investment required by law. This reason is not in line with efforts to make investment incentives more accessible to SMEs by lowering the minimum qualification conditions. Thus, the Government did not take into account whether the investment was located in a state-supported region – the statistics show that it took into account mainly the high value added and the proportion of unemployed people in the region when making its decision.

Energy savings and transformation

The draft government regulation should contribute to meeting the energy goals of the Czech economy and the energy self-sufficiency of the Czech Republic by more targeted support for the production of technologies and equipment that will contribute to energy savings and energy transformation. A list of these selected products is provided in a newly added separate annex to the Government Regulation. These are mainly products for which a shortage or partial unavailability on the market has been identified and there is a need to support the increase of their production capacity and to achieve greater self-sufficiency of the Czech Republic in the manufacture of these products. However, the applicant will also have to demonstrate that, in the case of the intended investment, the products are intended for the production or storage of energy from renewable sources, for increasing energy efficiency or for reducing the energy consumption of buildings.

Increased support for the production of such technologies and equipment should then be ensured by the following changes in the setting of support conditions:

- Investments focused on these areas will be able to obtain an investment incentive in the form of material support for the acquisition of tangible and intangible fixed assets for strategic investment projects without having to reach a value of CZK 2 billion and create 250 new jobs;
- The rate of this material support for strategic investment projects would be increased by up to 20% of eligible costs in all regions (currently this level of material support is available only in the Karlovy Vary, Ústí nad Labem and Moravian-Silesian regions); this is the maximum possible rate, the specific amount of material support will continue to be decided by the government according to the current possibilities of the state budget and according to the assessment of the contribution of the investment project in relation to the required investment incentive in the form of this financial contribution;
- If the investment is approved by the government as a strategic investment, it will not have to comply with the higher value-added limits (we discuss these limits in more detail below).

The list of selected products to be newly supported includes e.g. heat pumps, photovoltaic systems, solar thermal systems, solar hybrid systems, heat recovery units and solar thermal panels, nuclear reactors and non-irradiated fuel cells, steam generators and condensers, water turbines, water wheels and their controllers, wind turbines, wind-powered generating sets, electrolysers for the production of hydrogen from renewable energy sources, hydrogen fuel cells, meters for the supply or consumption of gases, liquids and electricity, battery storage for electricity from renewable energy sources, insulation materials used as thermal insulation for structures and piping in the construction industry, Charging stations for electric vehicles, filling stations for hydrogen electric vehicles, biomass and electricity hot water boilers for indoor heating, power chips, traction batteries for electric vehicles and electric motors for electric vehicles.

Strategic autonomy

The current international situation and the unavailability of certain raw materials, components and technologies reinforce efforts to increase strategic autonomy. As a traditional industrial country, the Czech Republic is heavily dependent on supplies from Asia for certain sectors and technologies, which, as recent history has shown, can be disrupted. This then results in a shortage of certain raw materials, components and technologies, which can lead (and in several cases has already led) to the suspension of production of some key sectors of Czech industry. The European Commission has already responded to this situation with legislative initiatives that include public support for key investments by Member States.

Support for projects of common European interest should be ensured by the following changes in the setting of support conditions:

- These investment projects will be able to obtain an investment incentive in the form of material support for the acquisition of tangible and intangible fixed assets without having to meet the higher limits on the value of acquired tangible and intangible fixed assets and the higher numbers of new jobs created set for strategic investment projects.
- Material support should also be available for investment projects in software development centres, data centres and shared services centres.
- These projects should be exempted from the higher added value test (see below).
- Nor would the requirements for a minimum number of new jobs be applicable in the case of an investment project in a technology centre or in all types of investment projects in a strategic service centre.

The existing Annex listing the R&D sectors using key enabling technologies is extended to include semiconductor components in line with the Regulation establishing a framework of measures to strengthen the European semiconductor ecosystem (the so-called "Chip Act"). Specifically, the annex includes research and development in the production of semiconductor substrates for electronic applications, research and development in the production of integrated circuits, research and development in the design of digital integrated circuits, research and development in volatile and non-volatile memories based on integrated circuits and other semiconductor technologies, research and development of optical circuits and other optical elements for computing tasks, research and development of hardware elements of quantum networks, research and development of semiconductor elements of quantum computers, research and development of quantum computers.

Higher added value

As some compensation for the concessions described above, the new government regulation should to some extent tighten the conditions for obtaining the investment incentive for 'non-preferred' areas through higher value-added requirements, as follows:

- The condition of higher value added would be extended to all regions of the Czech Republic outside regions with unemployment of at least 7.5% (only the Karviná district currently meets the exception);
- Doubling the requirement to spend on collaboration with a research organisation to 2% of eligible costs;

- Increase in the compulsory share of R&D staff from 2% to 3%.

The wage criterion for the condition of higher added value of productive investments will now not be demonstrated by the average gross monthly earnings of 80% of the employees, but by the total average wage of the recipient's employees at the location of the investment project. The total average monthly gross wages of all employees of the recipient at the place of implementation of the investment project over the calendar year should be taken into account. The number of employees at the location of the investment project should include the registered number of employees of the recipient of the investment incentive with a place of work at the location of the investment project, converted into the specified weekly working hours. The total average monthly gross wages thus determined will then be compared with the average monthly gross wages in the region published by the Czech Statistical Office for the previous calendar year.

Certain strategic investment projects should be exempted from the tightened higher value added limits described above, e.g. the aforementioned investment projects aimed at increasing the production capacity of products needed to implement the necessary energy transformation of the Czech Republic.

In addition to simplifying the approval of applications for the investment incentive, the draft government regulation should also contribute to meeting the energy goals of the Czech economy, the Czech Republic's energy self-sufficiency and increased strategic autonomy in line with the European Commission's initiatives.

Effectiveness

The new rules will not be effective until the second half of 2023 at the earliest, but more realistically not until 2024.

If you have any questions about the content of the amendment and the related implementing regulation, including their potential practical implications for applicants for investment incentives, please contact the authors of the article or your usual EY team.

Judicial window

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Supreme Administrative Court on the question of the taxability of income in connection with the return of recovery of damages

In this issue, we present an interesting judgment of the Supreme Administrative Court ("SAC") regarding the return of recovery of damages and the related factual and temporal context from the perspective of the Income Tax Act and, as a bonus, the court's reasoning on the taxability of income.

Background

- In December 2018, the company (investment fund) filed a supplementary corporate income tax return for the 2012 tax year in which it reduced the tax base by a significant amount, the reason for the reduction in the tax base being the refund of the amount to the Czech Republic.

- This amount was accepted by the company in 2012 as compensation for damages on the basis of a final judgment of the Municipal Court in Prague of September 2012, which was later overturned by the Supreme Court in its judgment of June 2014. Subsequently, another lawsuit for the recovery of unjust enrichment (compensation received) was pending, in which the company was ordered to reimburse the Czech Republic for the amount it collected as compensation in 2012.

  In its November 2018 judgment, the Municipal Court found that the Czech Republic was not obliged to pay the applicant under substantive law. If it had done so on the basis of the final judgment of 2012, the company had been unjustly enriched by the annulment of that judgment, in the form of a performance for a legal reason that later ceased to exist.

- The tax administrator did not accept the described reduction of the tax base for 2012, pointing out that the obligation to pay the compensation was not imposed on the company until the judgment of 2018. The reimbursement of the compensation is therefore linked in timing and substance to the tax year 2018, not to 2012.

View of the Municipal Court

- The Municipal Court annulled the decision of the tax administrator (more precisely, the Appellate Financial Directorate) and remanded the case for further proceedings.

- The tax administrator proceeded on the basis that considering the transaction in 2018 reflects economic logic, since the transaction in 2012 actually manifested itself in the company's assets, where it remained until 2018, while until 2014 the company disposed of the amount received, thus disposing of the amount at its discretion and based on its business decision-making. However, according to the court, it may not be entirely irrelevant to the extent to which the assessment of the substance and timing of the reimbursement will affect the company's tax position, i.e. in particular whether, given the level of tax bases in the years 2013-2018, the company will realistically be able to fully realise the tax loss resulting from the reimbursement in 2018. While the timing of taxation cannot be tailored to economic needs, there is no escaping the fact that the reasons presented by the tax authorities for taxing the 2018 refund were incorrect or unconvincing.

- The Municipal Court also pointed out that, although the company had accepted the funds in 2012, it had immediately been challenged via an appeal and the company itself had, out of caution, negotiated with the public authorities to find an accounting and tax solution that would reflect its doubts about the permanence and immutability of the situation created by the 2012 judgment.

- As a result, the company was, inter alia, conservative with the funds received and kept them in special accounts without using them for collective investment activities. However, the tax administrator failed to address or properly assess these circumstances.

View of the SAC

- The SAC dismissed the tax administrator's cassation complaint.

- In the view of the SAC, two basic issues need to be clarified:

    - whether the applicant earned income for tax purposes in 2012, and if so,

    - whether the income was real and not merely seeming, i.e. whether it was taxable income.

1. At the time of income generation

- The annulment of the 2012 judgment had the effect, according to the civil courts, that the legal basis on which the Czech Republic had paid the company in 2012 no longer existed. This, in itself, therefore, does not alter the fact that the company had in fact already acquired the funds and that they were at that time rightfully part of its assets. The 2018 judgment did not "dispose" of these assets, but created a (new) obligation for the company to release from its assets a sum of money corresponding to the amount of compensation received, as it had been holding them illegally or without justification since the 2012 judgment was set aside.

- The tax administrator therefore acted in accordance with the conclusions of the civil courts when it distinguished between, on the one hand, the award and payment of compensation and, on the other hand, the subsequent creation of unjust enrichment and the obligation to repay it. These are separate moments, which also have separate tax-relevant effects in terms of the generation of income on the part of the company in 2012.

- The tax administrator's conclusions concerning the actual generation of the company's income in 2012 are therefore factually correct. In its conclusions regarding the existence of income on the part of the company, the Municipal Court did not take sufficient account of the factual situation that occurred in the tax year 2012, i.e. that the company was regarded as the legal and economic owner of the funds in question, which was received for a legal reason that ceased to exist after the end of that tax year. This reality cannot be overcome ex post by finding that, according to the judgments of the civil courts, the company was never entitled to compensation.

2. On the question of taxability of income

- Income subject to income tax is an increase in the taxpayer's assets, which must be real and not merely seeming. This means that this increase in assets must be actually reflected in the taxpayer's legal affairs in such a way that it is actually usable by the taxpayer. Income that is not real but only seeming is not taxable, even if it is accounted for as income (revenue).

- In this specific case, the tax authorities did not get the question of the 'reality' of the income entirely right and therefore reached an unacceptable conclusion.

- Even in the opinion of the SAC, it was appropriate to refer the case back to the tax authorities for further investigation on the question of the reality of the income in question. In these further proceedings, it will be for the tax authorities to consider, in accordance with the above, whether the Czech Republic's payment on the non-existent debt in 2012 had a real impact on the company's assets, precisely in view of the alleged and proven substantial limitations on the company's use of funds for its normal business activities resulting from the instructions of the CNB and the depositary. First of all, it must be ascertained whether, and if so to what extent, the company was actually restricted in the use of the funds it received from the Czech Republic as a result of the continuation of the dispute. Here, it is necessary to consider what is the standard content of a property right, and how freely and arbitrarily the company could dispose of the funds, given that it was operating in an industry subject to a strict regulatory framework, and the regulator should have given it directions as to the holding and disposal of the income in question. If it turns out that the compensation received by the company, as a result of the regulator's action to which it is subject under the relevant legislation, was in fact a resource that was objectively unusable, or a resource that did not actually manifest itself in the company's legal affairs, then it will be appropriate to apply in this specific case the conclusions of the above-mentioned case law concerning income that is only seeming.

So we'll see what this case eventually brings in the next round. It's interesting to note that the question of factual vs. seeming income comes up in case law from time to time and in practice there may be situations where it can be an attractive line of argument.

If you are interested in this area, please contact the author of the article or your usual EY team.

Income subject to income tax is an increase in the taxpayer's assets, and it must be real income and not merely seeming income. This means that the increase in wealth must be actually manifested in the taxpayer's legal sphere in such a way that it is actually usable by the taxpayer. Income which is not real but only seeming is not taxable, even if it is accounted for as income (revenue).

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Positive ruling on the deductibility of interest on an acquisition loan

This time we bring you an interesting judgment of the Regional Court in Prague on the deductibility of interest on acquisition loan - and an exceptionally positive one!

Situation

- The case dealt with the deductibility of interest on a bank loan that financed the acquisition of a Czech operating company from foreign related parties with a subsequent merger into a Czech acquisition SPV.
- Our understanding is that this occurred after the new investor entered at the top tier of the ownership structure and effectively was a "push-down" of the acquisition financing to the group's operating entities.
- The tax authorities disallowed the deductibility of the interest on the basis that the transactions relating to the debt transfer appeared to be tax driven and without economic justification and were carried out so as to result in an illegitimate tax advantage.

Selected arguments of the company

- The tax authorities did not address whether the company could have realised a tax advantage in relation to the contested transactions. If there is a tax deductible expense in the Czech Republic and it is countered by interest income abroad which has been duly taxed, there is no tax advantage.
- The loan was granted by an independent consortium of banks, which conditioned the granting of the loan to investment group G to finance the takeover of group T on the transfer of the debt to the company, as evidenced by a declaration by the financing consortium of banks.

- The company explained and demonstrated that the main reason for the loan, the purchase of the equity stake and the subsequent merger was the requirement of the consortium of banks that provided the financing in the context of the ongoing restructuring of the whole group T. The transfer of the debt to the company was a key requirement of the consortium of banks. If this condition had not been met, the consortium would not have allowed the transaction to be financed, as the company has demonstrated by statements from the financing banks themselves. This requirement is logical and normal in a situation where the parent company is a holding company holding shares in T group companies and collecting only passive income from holding these shares. It is therefore far more acceptable for the bank to charge the loan to an operating entity that generates active business income and holds assets, as it is more likely to pay interest regularly or to be able to recover it more easily.

- The company does not dispute that an outright merger could have occurred, but this type of transaction would not have resulted in a change in the company's financing to predominantly loan financing. The economic rationale for the chosen arrangement could not have been realised in the case of a mere direct merger of two sister companies. The alternative way of achieving the desired objective (a direct merger with a loan from a third party for the payment of free funds in the form of dividends) not only leads to an identical value result but has the same tax implications.

- It is not clear to the company what the tax authority sees as the element of abuse of rights if (i) the owner of the company had a legitimate claim to enforce the change of financing from own to third party financing, (ii) the change was made at the request of external banks, i.e. for standard economic reasons, (iii) and according to the case law the solution could have been chosen. The direct merger option advocated by the tax administration has the same tax effect as the transaction carried out by the company.

- This is not altered by the case law in CTP case, which involved intra-group financing. In the case of the company, the effects of the loan were positive, the loan was quickly repaid and the company grew economically.

Selected arguments of the tax administrator

- The merger could have taken place without the purchase of the shareholding, as both companies were controlled (directly or indirectly) by the foreign parent company T and the investment group G respectively.

- The acquisition and change of ownership occurred at the top level of the ownership structure, before the intra-group transactions which did not bring any new assets to the group.

- Company that did not have any business activity, assets or funds was sold shares in a Czech operating company by foreign related companies in the order of hundreds of millions of crowns, which would not have been possible if the companies were not related parties.

- There was no direct flow of funds from the bank to the company, but the debt was transferred by way of set-off of liabilities and receivables related to the purchase of the shareholding in the Czech operating company.

- A change of ownership in the upper tiers of the structure does not explain or justify the economic rationale for the changes and transactions (purchase of a business stake, drawdown of a loan, merger) if they occurred several months after the change of ownership in the upper tiers of the structure.

The Regional Court's view

The court sided with the company - its selected arguments:

- The drawing down of a loan to purchase a share in a sister company with which it could only merge without the intermediate step of purchasing its share (paid for by the loan) appears irrational in view of the purpose of section 24(1) of the Income Tax Act. The purpose of taking out the loan could not have been to develop its own economic activity, which the company did not actually carry out at the time. Indeed, if the company intended to develop its economic activity precisely through its sister company, which was at that time a prosperous economic unit, it would have been economically rational for the merger to have taken place without the company incurring a heavy credit burden at the same time.

- However, the Court sees the main economic reason for the transactions described as enabling the acquisition of Group T by the new owner, the investment group G. All the actions of the related parties were guided by that reason, namely to facilitate the takeover of Group T. The Court therefore also considers it to be of central importance that the reasons for which it proceeded to purchase the shareholding in the Czech operating company by means of a loan and only subsequently to the merger stemmed in particular from the conditions of the external bank.

- Unlike the CTP case, in which a loan was granted by a related party, and it was therefore entirely appropriate to examine whether such a transaction had rational grounds and whether the restructuring was not merely a formal cover for obtaining a tax advantage, it is relevant in the present case that the conditions under which the takeover of the group took place originated with an external lender which set the terms of the financing.

- If the terms of the loan were set by an external entity (the lending bank), it can hardly be assumed that the bank deliberately set the terms in such a way as to create an artificial structure designed to obtain an unjustified tax advantage (the tax authorities have neither alleged nor proved any such thing). On the contrary, the Court accepts the company's explanation that, by setting the conditions in question, the bank apparently wanted to ensure maximum efficiency in the repayment of the loan (by pushing it down on operating entities at a lower level in the group's hierarchy which actually generate a profit). Such an approach can, on the contrary, be considered economically rational.

- Of course, the above does not mean that compliance with the terms of the loan agreement excludes a priori the possibility of applying the abuse of rights principle. Indeed, it cannot simply be argued that any requirement of the bank makes economic sense. However, in such a case, the tax authorities would have to prove that the terms of the loan agreement were set up in a certain way precisely for the purpose of the creation of an artificial economically irrational structure aimed at obtaining an unjustified tax advantage, or that the banks could have achieved the same result in other ways. However, the tax authority did not conduct its reasoning (or evidence) in that direction.

- The tax authority ignores the broader picture of the transaction. The primary economic objective of the entire transaction was not the acquisition of the assets of the Czech operating company, but the takeover of Group T by means of credit financing, which was to be transferred to the operating entities (for good reasons). The Court considers it to be of central importance that the actions of all the parties to the transactions described were to carry out that takeover, and that in order to complete the transaction the conditions of the lending bank had to be fulfilled. It is therefore impossible to agree with the tax authorities that the company could have merged with the operating company in question without incurring credit indebtedness, since the purpose of the entire transaction, namely the takeover of Group T by the new owner, could not have been fulfilled. The procedures concerning the company were part of a broader process essentially independent of the will of the members of Group T.

- The transactions would have to be assessed differently if the loan had been granted by a related party.

- It seems logical to the Court that the bank had good reasons for pushing the loan to a thriving Czech operating entity. The bank intended to strengthen its position as a creditor by bringing the loan down to a lower level where the assets of the prosperous company would meet an obligation to the bank which could be directly paid from or secured by the assets of that company. The loan is to be allocated to an operating entity that generates active business income and holds assets. Thus, there is a greater expectation of regular interest payments or easier recovery in the event of non-payment of interest or principal.

The tax administration has filed an appeal, so we'll see what the Supreme Administrative Court thinks. In any case, in our opinion, it is essential to assess each similar transaction (debt push-down) individually and analyse the risk of abuse of law.

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